No. 14090

# United States Court of Appeals

## For the Ninth Circuit

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HELGA CARLEN, JOHN T. CARLEN, CATHRYN McKAY, ARTHUR R. McKAY, ARTHUR R. and CATHRYN McKAY and JOHN T. and HELGA CARLEN, *Appellants,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Appellee.*

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APPEAL FROM THE TAX COURT OF THE UNITED STATES

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## BRIEF OF APPELLANTS

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APPEAL FROM THE TAX COURT OF THE UNITED STATES

## BRIEF OF APPELLANTS

### STATEMENT OF JURISDICTION

This is an appeal from a final decision entered by the Tax Court of the United States. Appellants petitioned the Tax Court of the United States for a determination that no additional income taxes beyond those agreed upon by stipulation were due for the taxable years 1947 to 1950 inclusive as claimed by the Commissioner of Internal Revenue. The Tax Court rendered a final decision adverse to appellants and timely notice of appeal was thereupon given. This appeal is taken pursuant to the provisions of Title 26, U.S.C.A. Section 1141.

### STATEMENT OF THE CASE

The controversy relates to the proper determination of appellants' liability for federal income taxes for the calendar years 1947, 1948, 1949 and 1950. Appellants Arthur R. McKay and Cathryn McKay are members

of a marital community residing at Aberdeen, Washington. Appellants John T. Carlen and Helga Carlen are members of a marital community residing at Raymond, Washington. For the calendar year 1947 the members of each community filed separate federal income tax returns. For the calendar years 1948, 1949 and 1950 each community filed joint returns. All returns were filed with the Collector of Internal Revenue, Tacoma, Washington.

In 1945 appellants, Arthur R. McKay and John T. Carlen, formed a partnership to purchase, log, cut and sell timber in the southwestern part of the State of Washington. On April 23, 1945, the partnership entered into a contract with Neuskah Timber Company to purchase, log, cut and sell certain standing timber previously purchased by Neuskah, located on the land of a third party, Rayonier, Incorporated. The partnership was to purchase and remove all merchantable timber, build and pay for all necessary roads and to sell certain species of logs to Neuskah (later Bishop) or to Rayonier and had the right to sell other species to third parties. The partnership paid fixed stumpage as the timber was cut and sold and engaged Neuskah (later Bishop) to act as sales and billing agent for the partnership at $1.00 per thousand.

In January, 1946, Neuskah merged with its parent corporation, E. K. Bishop Lumber Company, and Bishop assumed Neuskah's contract with the partnership. In 1946 and 1948 Bishop entered into three additional contracts with Rayonier and immediately orally assigned them to the partnership on the same terms as

the original contract between Neuskah and the partnership, except for different stumpage prices.

From 1945 through 1950 the partnership performed the aforesaid contracts. Gain realized under the contracts was reported by appellants as long term capital gain under Section 117(k)(1) of the Internal Revenue Code. It is agreed by stipulation that appellants are not entitled to the provisions of Section 117(k)(1) of the Internal Revenue Code except as to those contracts held for more than six (6) months prior to the commencement of each taxable year herein under review. The Tax Court affirmed the Commissioner's determination that appellants are not entitled to the benefits of Section 117(k)(1) and that all gain realized is taxable as ordinary income and from the decision of the Tax Court this appeal is taken.

## QUESTIONS PRESENTED

1. Were appellants engaged in logging under a service contract or were they logging and selling timber for their own account?

2. Are the appellants entitled to report their gains realized on the sale of timber as capital gains under Section 117(k)(1) of the Internal Revenue Code?

## SPECIFICATION OF ERROR

The appellants assign as error the following acts and omissions of the Tax Court:

1. The finding that appellants are not entitled to compute their gain realized on the sale of timber, purchased and cut in accordance with the subject contracts, under Section 117(k)(1) of the Internal Revenue Code.

2. The finding that appellants, through their partnership, McKay and Carlen, were not engaged in the business of cutting timber for sale on their own account.

3. The finding that Neuskah (later Bishop) did not retain title to the timber until cut and sold, for security purposes only.

4. The finding that the partnership was employed to cut timber for compensation only.

5. The finding of deficiencies in income tax against all appellants for the taxable years 1947 through 1950 inclusive, in excess of the amounts agreed upon by stipulation.

6. The decision of the Tax Court is contrary to the evidence and the law for the following reasons:

(a) The findings of fact upon which the Court's decision is based, are not supported by substantial evidence and are contrary to the testimony of all witnesses as to the ownership of the timber and the right to sell the timber cut by the partnership.

(b) The Court's decision is contrary to the facts as found.

(c) The Court erred in interpreting the requirements of Section 117(k)(1) of the Internal Revenue Code.

## ARGUMENT

### A. Appellants Had a Contract Right to Cut Timber for Sale for Their Own Account

The partnership entered into four contracts with Neuskah and Bishop for the purchase of timber on a pay-as-cut basis, with the terms set forth in the first contract dated April 23, 1945 (Exhibit No. 2; Tr. 16). The three subsequent contracts were oral and were in accordance with the first contract except as to variations in stumpage prices (Stip. 15). The first contract was later orally amended to include hemlock (Stip. 11). It is submitted that the contract and the parties' interpretation of the contract clearly show that the partnership had a contract right to cut and sell timber and that the Tax Court's findings of facts are not supported by the preponderance of the evidence.

#### 1. *Risk of Loss*

The partnership assumed the entire risk of loss of the operation. It was not entitled to reimbursement of any kind for its expenditures. On the other hand, all profits realized on the timber belonged to the partnership (Exhibit No. 2; Tr. 16, 47, 48, 49). This is definitely not a contract for the performance of logging services for in the service type of contract the logger is paid a fixed fee for timber cut regardless of specie (Tr. 39, 47).

#### 2. *Roads*

The partnership built all the necessary roads at its own expense and built roads six to seven months in advance of logging operation (Stip. 12; Tr. 47, 48, 49, 50,

53). In a service type of contract the owner builds and pays for the roads (Tr. 39, 42, 47).

**3. *Invoicing***

The partnership engaged Neuskah (later Bishop) to invoice all logs of the partnership to the buyer, hemlock to Rayonier, spruce to Bishop and fir and cedar to third parties. For this service Neuskah (later Bishop) charged the partnership $1.00 per thousand (Stip. 13; Tr. 51, 52, 54, 58, 59, 60; Exhibits 2, 11, 12, 13).

Bishop invoiced the logs in its own name and sent copies of the invoices together with detailed information to McKay and Carlen to indicate the amount due the partnership for its logs as the sales were usually for rafts of logs including the logs of owners other than McKay and Carlen. In accordance with the basic contract the logs were trucked to Willapa Harbor and were scaled, rafted and towed to the designated delivery points; all these expenses were borne by the partnership. It would be wasteful for Bishop to send out a number of invoices to the buyer to cover the logs of each owner included in the raft and identified by different brand names so one invoice in the name of Bishop was used for each raft as is shown in the exhibited invoices (Exhibits 11, 12, 13) and individual accounting was made to each owner on a memorandum sheet sent to the owner with a copy of the invoice for each raft or the data appeared on the foot of the invoice where space permitted. The invoices show the raft number, the brands of the various owners, quantities and species of logs of each owner with extended pricing. In the case of McKay and Carlen deductions were taken for stump-

age, booming, rafting and scaling charges, and $1.00 per thousand for invoicing and handling disbursements of the proceeds (Exhibits 11, 12, 13; Tr. 58, 59).

The Tax Court specifically erred in its conclusion as to the significance of the invoicing (Tr. 24). There is absolutely no evidence to support the Court's finding that Bishop's invoicing to itself was "for bookkeeping purposes" only. The uncontradicted testimony of the independent certified public accountant, Aiken, together with an examination of the invoices themselves clearly indicate that Bishop was selling the logs for McKay and Carlen (Tr. 58, 59, 60). Bishop had to invoice itself for logs of McKay and Carlen and other parties because the logs belonged to McKay and Carlen and the other owners (Exhibit 11).

The Court failed to attach significance to Mr. Aiken's testimony with reference to the markings on Exhibit 11, "SJ 27" and "PJ 27" meaning that the sales price had been entered on Sales Journal 27 and the stumpage had been entered on the purchase journal of the partnership (Exhibit 11; Tr. 60). On Exhibit 13 there is found the accountant's markings placed on the invoice when received by the partnership indicating that the gross sales price should be entered on "Sales Journal 21" and that the stumpage payments should be entered on "Purchase Journal 20." The manner in which the partnership handled the accounting for these transactions indicates clearly that the appellants at all times considered that they were purchasing and selling the timber.

**4. *Discount***

Further evidence that the invoicing of Bishop was for

the account of McKay and Carlen is found in the fact that Bishop was entitled to and did take the customary cash discount of 1% on sales to itself (Exhibit 11) which is the same discount taken on sales to Rayonier and to E. C. Miller Cedar Lumber Company (Exhibits 12 and 13). Certainly if Bishop was at all times the owner of the timber as found by the Court then why did Bishop invoice itself for the spruce, why did it take a 1% discount for prompt payment?

**5. *Stumpage***

The basic contract between Neuskah and the partnership was not prepared by counsel but by Mr. Maw, accountant for Neuskah and Arthur R. McKay (Tr. 47). While they attempted to follow the earlier contract between Rayonier, the original owner of the timber, and Neuskah, they used terms familiar to them and drew a contract which they regarded as adequate. The uncontradicted testimony of Mr. McKay as to the meaning of the contract is entitled to great weight. The contract itself, when interpreted by those familiar with logging terms is definitely a contract of purchase. The contract states "The parties hereto agree that from the total net cash return from the *sale* of all logs shall be deducted '*stumpage*' * * *" (Italics ours).

Loggers understand the term "stumpage" when used in the sense of payment, to mean payment for the timber at time of cutting or sale. Basically there are two principal types of arrangements for the purchase of timber, lump-sum payment or "pay-as-cut." The subject contract is of the latter type. In the pay-as-cut purchase, the term stumpage is used to express the measure

of payment. Chapman and Meyer in their book "Forest Valuation," page 363, state:

> "Pay-as-cut is distinguished from lump-sum payments, which are frequently made for timber purchased in small quantities from woodlots for immediate cutting. In the former case, the payment is based on the measured quantity of timber in the log or after sawing, subsequent to cutting, and thus conforms directly to the actual quantities purchased. Lump sum payments, by contrast, are purchases of standing timber previous to cutting, on the basis of a cash offer for the timber as it stands. Such transactions are often made without the benefit even of estimates of the volume and quality of the standing trees and nearly always work to the detriment of the owner, who may receive only about one-half of the sum that he would realize by pay-as-cut methods based on *stumpage* prices segregated by species, products, and quality." (Italics ours)

Walter Mucklow in "Lumber Accounts," page 441, defines "stumpage" as "The price per thousand feet paid for standing timber * * *."

> " * * * 'Stumpage' is a term used to express the price paid or to be paid by the purchaser for standing trees to be severed from the soil and converted into timber or logs by the purchaser." *Neidlinger v. Mobley,* 76 Ga. App. 599, 46 S.E.(2d) 747, 750 (1948)

**6. *Retention of Title***

The Tax Court emphasized the fact that while Rayonier reserved title to the timber until cut, Neuskah (later Bishop) as between itself and the partnership reserved title until the logs were cut and sold (Tr. 24,

25). As stated by Mr. McKay, title was retained for a longer period by Neuskah because of the fact that the partnership had limited financial resources as compared to Neuskah and Bishop and the seller thought it necessary to protect itself as long as possible (Tr. 56).

In other business fields it is a common practice for the money lender or prior owner to retain title until sale such as in trust receipt financing and flooring arrangements, yet no one questions the fact that the merchant is the owner of the goods sold and is acting for his own account and not as agent for the lender or prior owner.

If Neuskah and Bishop were only having the partnership act as service loggers and the partnership had nothing to sell (Tr. 24, 25), then why did Neuskah (later Bishop) need to make any reference to reserving title, particularly as to spruce, all of which was purchased by Bishop from the partnership. In other words, if Neuskah (later Bishop) as between itself and the partnership at all times owned the timber, then no purpose was served by specifically reserving title until the logs were sold. An examination of the basic contract shows that the draftsmen of the contract were not guilty of verbosity; in fact, only the first contract was written, the other three were oral.

**7. *Logging Restrictions***

The partnership was required to cut the timber in a definite manner and to operate forty-eight hours per week (Exhibit 2). These conditions cannot be construed to make a contract of purchase one of service. The contract of March 15, 1945 (Exhibit 1), between Rayonier and Neuskah and the three subsequent contracts be-

tween Rayonier and Bishop all had similar provisions requiring the purchaser to

> "go upon said lands and commence operations hereunder immediately, and * * * carry on such operations diligently and continuously to completion."

Yet the Tax Court correctly found that the Rayonier contracts were contracts of sale (Tr. 24). The land owner on a pay-as-cut basis wants to make certain that the timber will be removed as soon as possible. Buttrick in "Forest Economics and Finance," page 368, states:

> "Stumpage is bought and sold under the following forms of agreements: (1) Land and timber are sold jointly; (2) the purchaser buys all timber without buying the land and without any conditions as to time or method of removing the timber; (3) the seller disposes of all or part of the timber with stipulations as to time for removal, methods of operation, and so on, and retains the land.
>
> "A sale including land and timber is fair to both parties providing the price is fair to both. One involving only the timber, but without stipulation as to time in which it is to be removed, ordinarily is completely against the interests of the landowner because it gives the purchaser the effective use of the property as long as he desires, leaving the landowner only the satisfaction, if any, of ownership and the duty of paying taxes. Such sales occasionally are made by owners who think that the timber is to be removed at once; later they learn the import of a bad bargain."

The fact that the hemlock was to be sold to Rayonier and the spruce to Neuskah and Bishop at the prevailing market price at the time of the sale does not make the

transaction less than a sale by the partnership. See *Springfield Plywood Corporation v. Commissioner,* 15 T.C. 697 (1950), where title was retained until timber was cut and where the prior owner had first right to buy back the logs, yet the Court held the agreement to be a sale or disposal of the timber.

**8. *Business of Partnership***

The Tax Court drew an improper inference from the stipulation of facts in which it was stipulated that the partnership was engaged in the "trade or business of logging timber" (Stip. 10). It is obvious that counsel for the appellee would not specifically agree in the stipulation that the term "logging" included "the purchase and sale of timber" but insisted that if the appellants were engaged in the business of purchasing and selling of timber then they would have to put on proof to that effect, which was done by the uncontradicted testimony of McKay and Aiken (Tr. 47, 48, 50, 51, 52).

**9. *Method of Payment***

No merit should be given to the argument that since Neuskah (later Bishop) collected all receipts and paid all expenses including stumpage and its own service fee of $1.00 per thousand, that the partnership never "paid" the items deducted by Neuskah and Bishop. It is a matter of common knowledge that selling agents for timber, fish and agricultural products often do all the bookkeeping and deduct all charges and make all remittances for the actual owner of the product without effecting any change in the legal relationship of principal and agent.

**B. Appellants Are Entitled to Report Their Timber Sale Gains as Capital Gains Under Section 117(k)(1) of the Internal Revenue Code**

It is established by the evidence that the partnership had a contract right to cut timber and to sell the logs purchased under the cutting contract for its own account and that the contracts were held for the required holding period and that it took the proper method of electing to take the benefit of Section 117(k) and the corresponding benefit of Section 117(j) in its tax returns (See Appendix).

Section 117(k)(1) clearly provides that its provisions can be elected by a "taxpayer who * * * has a contract right to cut * * * timber." There is no requirement in the statute that the taxpayer must have a prior proprietary interest in the timber for then he would be the owner of the timber and is clearly covered by the statute, but the statute goes on to provide that the statute covers a taxpayer who has "a contract right to cut" and who realizes gain on the sale of the timber. The partnership had a contract right to cut timber and did realize and retain the gains from the sale of the timber.

As stated by the Tax Court this is a case of first impression (Tr. 22) and an examination of the legislative history is helpful as is a review of the articles of authors who have studied Section 117(k).

The report of the Senate Finance Committee of the Senate, Revenue Bill of 1943, 1944 C.B. 973, 993, states:

> "Your committee is of the opinion that various timber owners are seriously handicapped under the Federal income and excess profits tax laws. The law discriminates against taxpayers who dispose of

> timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess profits tax rates and not at capital gain rates. In short, if the taxpayer cuts his own timber he loses the benefit of the capital gain rate which applies when he sells the same timber outright to another. Similarly, owners who sell their timber on a so-called cutting contract under which the owner retains an economic interest in the property are held to have leased their property and are therefore not accorded under present law capital-gains treatment of any increase in value realized over the depletion basis."

The Court of Claims statement in *Boeing v. United States,* 98 F.Supp. 581 (1951), as quoted by the Tax Court (Tr. 23):

> "The legislative history of 117(k) indicates that Congress' principal purpose was to afford relief to timber owners."

does not and could not mean that the section was not to apply to persons having a contract right to cut timber. In fact the Court refused to limit Section 117(k)(2) to leases when the defendant (United States) attempted to apply such a restriction by relying on the Senate Finance Committee Report.

In the hearings before the Committee on Ways and Means, House of Representatives (78th Congress, 1st Session) for the Revenue Act of 1943, the statement of Lowell H. Parker, appearing for the Forest Industries Committee on Timber Valuation and Taxation (active sponsors of Section 117(k)) given on October 14, 1943, page 799, states:

"Operators who hold contracts giving them the right to cut timber from the land of another are in practically the same situation as the forest owners who cut their own timber and should be accorded the same relief. In general, the proportion of capital gain to operating profit will be less than in the case of the forest owner who cuts his own timber because usually the time for which held is less.

"Forest property owners who cut their own timber and operators who cut timber from the land of another under a contract, would be equitably treated under our proposed section 117(k)(1) which has been submitted to this committee."

William A. Hamilton in the Florida Law Journal, November, 1949, in his article "Gain or Loss on the Cutting and Disposal of Timber," gives his interpretation of Section 117(k) in the following example at pages 312 and 313:

"An example will illustrate the operation of section 117(k)(2): Refer again to Atlantic Lumber Company and its tract of timber, in which Atlantic has a depletion basis or cost of $5.00 per thousand feet. On June 1, 1947, at a time when Atlantic had owned the timber more than six months, it executed a cutting contract or lease in favor of Baker Lumber Company, also a manufacturer and seller of lumber at wholesale. The contract provides that Baker shall have the right for five years to enter upon certain portions of Atlantic's tract, to cut and remove specified timber, for which Atlantic is to be paid as cut the sum of $10.00 per thousand feet. Under the contract Atlantic retains title to the land and title to all timber until actually cut by Baker. In 1948 Baker cut one million feet of timber from the tract and paid Atlantic the required sum of

$10,000.00 therefor. Since Atlantic's depletion basis in the timber so cut is $5,000.00, the excess of $5,000 received by Atlantic is treated and taxed under section 117(k)(2) as a long term capital gain in the taxable year 1948 if total gains exceed losses under section 117(j). Under the pre-1943 law, the $5,000.00 excess received by Atlantic would have been taxed as ordinary income. *To further illustrate the over-all operation of section 117(k), if the one million feet of timber cut by Baker in 1948 had a fair market value of $15.00 per thousand feet on January 1, 1948, and the timber was cut by Baker for sale or for use in its business, Baker, by electing the provisions of section 117(k)(1) for the taxable year 1948 also could obtain capital gains treatment on $5,000.00. That is, if Baker's total gains exceed losses under section 117(j), it would obtain capital gains rates with respect to the timber cut in 1948 based on the difference between the January 1, 1948, fair market value of $15.00 per thousand feet and Baker's depletion basis of $10.00 per thousand feet.*" (Emphasis ours)

The same interpretation of Section 117(k) is to be found in a pamphlet written by Charles W. Briggs, "Timber Valuation and Taxation," published by Forest Industries Committee, 1319 18th Street N. W., Washington 6, D. C., in which he states at page 13:

"CASE TO WHICH THE PROVISION IS APPLICABLE. Section 117(k)(2) applies to an owner of timber:

"1. Who owns timber for more than six months before disposal; and

"2. Who disposes of it under a contract by virtue of which he retains an economic interest.

"It is safe to say that an economic interest is retained by the owner where he is to be paid:

"(a) so much per M as the stumpage is cut;

"(b) out of the production from the stumpage disposed of; or

"(c) out of the gross proceeds of the sale of the product of the stumpage by his transferee.

"(*It should be mentioned here that the taxpayer who acquires timber under such a contract is entitled to the benefits of Section 117(k)(1), that is, when he cuts the timber the difference between his cost under the contract and the market value is entitled to capital gains and loss treatment, as explained above in Division 1*)." (Emphasis ours)

The same analysis of 117(k) is made in a handbook prepared by the United States Department of Agriculture. "The Small Timber Owner and His Federal Income Tax" (1953) in which the preface contains the statement "This publication has been reviewed and approved by the Bureau of Internal Revenue, Department of the Treasury, Washington, D. C."

C. W. Shatley, certified public accountant, states in his article "Capital Gain Under Section 117(k)(1) of the Code," appearing in "Taxes," February, 1953, page 135:

"In essence, a timber-cutting contract (sometimes called 'timber lease') is merely a license granted by the owner of timber permitting the cutting of timber on his lands. (Of course, the ownership of the timber and the land may be held by different persons but this is rare.) Ordinarily, the owner of the timber will be paid per M board feet of logs removed, with a different price for each species. Sometimes, a lump-sum payment is made for all the timber on a tract of land with the risk of quantities falling on the purchaser.

"The various types of cutting contracts are too numerous to cover in this article. However, the Bureau has been attacking the classification of some contracts as cutting contracts under the statute where, because of title-retention provisions or covenants to sell the logs to the timber owner, the form does not comport precisely with the most common form of cutting agreement. Where a rise or fall in the market value of timber rebounds to the benefit or detriment of the logger, it would seem to be in keeping with the spirit of Section 117(k)(1) to permit the logger to report the cutting as a sale or exchange regardless of technicalities concerning the form of the contract."

## CONCLUSION

Since the decision of the Tax Court is not supported by the evidence and since the Court did not properly apply the applicable law, the decision should be reversed.

Section 117(k)(1) is not ambiguous and its clear intent entitles the appellants to the benefit of said section either on the basis that appellants purchased the timber and were the owners thereof at all times (subject to the reservation of title for security purposes) or had a contract right to cut such timber and to sell the timber or logs in the regular course of appellants' business and that the evidence clearly establishes that all other requirements of Section 117(k)(1) were met by appellants and their partnership.

Respectfully submitted,

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## APPENDIX

Section 117(j) of the Internal Revenue Code states in part:

"(j) Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.

"(1) Definition of Property Used in the Trade or Business. For the purposes of this subsection, the term 'property used in the trade or business' * * * includes timber with respect to which subsection (k)(1) or (2) is applicable."

Section 117(k)(1) provides:

"(k) Gain or Loss in the Case of Timber or Coal.

"(1) If the taxpayer so elects upon his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this paragraph such election shall apply with respect to

all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding upon the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Commissioner, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this paragraph except with the consent of the Commissioner.''